ISDA® Safe, Efficient Markets

April 8, 2014

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Advance Notice of Proposed Rulemaking – Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities (Docket No. R-1479; RIN 7100-AE10)

Dear Mr. Frierson:

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking concerning "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities" (the "**ANPR**") issued by the Board of Governors of the Federal Reserve System (the "**Board**"). ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivatives products. We are concerned that the Board may take actions that could impair the ability of financial holding companies to continue to contribute to well-functioning derivative markets. This is a concern broadly shared among our membership, and is not limited to our financial institution members.

Although the ANPR is focused on physical commodity activities, the physical and financial commodities markets are intrinsically linked. We believe that further significant limits on, or an outright or effective prohibition against, financial holding companies' participation in the physical markets may lead to less liquid and less efficient markets—both physical and financial—with the potential for higher costs and credit risk for end-users, which could impair or preclude beneficial merchandizing and hedging activities, leading to reduced consumer choice

1 Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

and greater market volatility. We strongly urge the Board to carefully weigh any potential actions that could curtail the ability of financial holding companies to provide these services against the significant benefits financial holding companies bring to commodity end-users and the commodities markets broadly.

Our comments focus on the participation by financial holding companies in the commodities markets under authority granted by the Board to certain financial holding companies to engage in activities that are complementary to financial activities ("**Complementary Activities**")[2] and under Section 4(o) of the Bank Holding Company Act.[3] Specifically, we are concerned that the Board may take actions that may unnecessarily restrict the ability of financial holding companies to continue to provide services as intermediaries in the commodities markets. Banking organizations fill the intermediary role in a variety of markets; as a result, they are adept at managing the risks associated with such activities. In addition, because their focus is on intermediation, financial holding companies provide a valuable service to customers—one that direct market participants may not be able to satisfy in a comparable manner.

Financial holding companies provide liquidity and other benefits to the commodities markets and market participants.

The involvement of financial holding companies in commodities markets enhances the liquidity and transparency of these markets, promotes price integrity, offers a source of high-quality credit and provides end-users with access to increased physical supply options and risk management alternatives.

a. Liquidity

A key role financial holding companies play in the markets is the provision of liquidity. Financial holding companies enhance liquidity by being willing to make prices in commodities and take on the role of market maker. Liquidity is critical to robust markets, and we believe that financial holding companies are well suited to provide this liquidity safely and efficiently. Further, we believe that the participation of financial holding companies as market makers in commodities has improved the liquidity of both the physical markets and the financial derivatives markets. Because they are among the entities with the highest credit ratings and most robust risk management infrastructures among market participants, financial holding companies introduce substantial liquidity to the markets, both through involvement in physically and financially settled products, at levels and in products (e.g., at locations and tenures) that cannot easily be replaced by other market participants. These entity characteristics also allow financial

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2 12 U.S.C. § 1843(k)(1)(B). Financial holding companies, through permission by the Board, can engage in physical commodity trading involving the purchase and sale of commodities in the spot market, and taking and making delivery of physical commodities to settle commodity derivatives ("Physical Commodity Trading"); pay power plant owners fixed periodic payments that compensate the owner for its fixed costs in exchange for the right to all or part of the plant's power output ("Energy Tolling"); and provide transactions and advisory services to power plant owners ("Energy Management Services").

3 12 U.S.C. § 1843(o).

holding companies to play critical roles as market makers in the case of commodities which are less liquid and traded in lower volumes overall.

Moreover, market experience has demonstrated that the physical commodity markets function less efficiently if participation is limited to commercial entities, because such entities generally enter into transactions as necessary to accommodate their own business needs, not for the purpose of accommodating counterparty demand. Intermediaries willing and able to make two-way markets, therefore, become essential to allow commercial parties to enter into transactions for hedging and other purposes. In addition, as detailed further below, should participation by financial holding companies in the physical commodities markets become more limited, their ability and willingness to enter into financial transactions on physical commodities to the extent needed by commercial participants may be impaired because of the inherent interrelationship between physical and financial markets.

In addition, the liquidity that banks provide to the physical commodity markets serves to mitigate the impact, if any, that speculation in these markets may cause. As intermediaries, financial holding companies have an interest in maintaining two-sided markets but not in the market moving in one direction or the other. Further, the participation by financial holding companies in the markets incorporates the input of a broader group of participants and results in greater transaction volume overall. In addition to the financial holding companies themselves, the intermediary role financial holding companies fill encourages participation in the physical commodities markets by end-users who may not be willing or able to engage in such markets otherwise. Therefore, through financial holding companies' participation in these markets, price discovery, liquidity and other market characteristics are more robust and better able to balance against any potential impact of speculative trading by single actors or small groups of participants.

b. Price integrity

As market makers, financial holding companies play a price discovery role. To fulfill that role efficiently, it is important for a financial holding company to be able to transact in both financial and physical commodities markets. By participating in both markets, financial holding companies help bring about price convergence—that is, the prices of the physical commodity and the prices of derivative contracts based on that commodity converge as the derivatives approach maturity. Price convergence increases market efficiency and creates further benefits for market participants, including reduced transaction costs, decreased market volatility, greater predictability and improved price discipline. A divergence between the price of a physical commodity and the price of a related financial derivative may result in a financial instrument being an inefficient hedge for a commodity price risk. As a result, the purchaser of the financial instrument may have to cover basis risk when the purchaser had intended to hedge its entire exposure, further reducing the anticipated efficiencies related to pricing and risk. If financial holding companies are precluded from participating or restricted in their participation in the physical markets, it is possible that the resulting reduction in liquidity will adversely affect price convergence, to the detriment of commercial market participants.

c. High-quality credit

As intermediaries, financial holding companies also can participate effectively in the markets because they are well-capitalized and creditworthy parties. The ability of financial holding companies to act as high-quality credit counterparties in commodities-related transactions is a strength that benefits both financial holding companies' customers and the markets more generally. The credit characteristics of financial holding companies allow them to achieve greater access at competitive prices that end-users acting directly in the market or through less creditworthy intermediaries might not be able to achieve. As a result, participation by financial holding companies in this role ensures the inclusion of large, stable market participants, as well as increased participation and diversity in the markets overall. Accordingly, risk is distributed across a greater number of market participants, including to financial holding companies with high-quality credit, end-users can diversify counterparty exposure and concentration risk is mitigated.

d. Risk management and supply

Many U.S. companies have exposure to physical commodity prices, which they often seek to manage through the physical and financial commodity markets. In order to hedge effectively, these entities typically look to entities, including financial holding companies, to assist them in managing the risks to which they are exposed. For example, an end-user that relies heavily on commercial fuel in its business, such as an airline, could look to financial holding companies to access liquidity and provide management of operational and pricing risk related to its supply of jet fuel. Similarly, a products company which uses copper in its manufacturing process may seek assistance in continually hedging base metal products in order to budget operational costs.[4] These types of entities might be able to hedge in other ways; for example, they could execute transactions directly in the futures markets. However, hedging alternatives may have their own risks (e.g., there is no liquid jet fuel futures contract, so hedging using futures includes significant basis risk). In addition, these alternatives generally require a level of management and market familiarity that commercial entities might not have. Financial holding company intermediaries can provide swaps that allow commercial entities to customize the terms of hedging transactions and avoid the expenditure on resources required for managing direct hedging in the markets.

In addition to the benefits realized for customers from a risk management perspective by financial holding companies' provision of hedging solutions, financial holding companies also provide operational and cost efficiencies to customers and valuable liquidity to the market by acting as well-capitalized and creditworthy suppliers of physical commodities. In the case of the airline described above, utilizing a major bank to provide as-needed physical delivery of its jet fuel through a long-term contract, rather than maintaining its own long-term inventory, allowed one airline to significantly reduce operational and logistical overhead and the need for related

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[4] For a discussion of relevant case studies, see IHS Global, "The Role of Banks in Physical Commodities", 2013, available at http://press.ihs.com/sites/ihs.newshq.businesswire.com/files/press_release/additional/IHS_Role_of_Banks_in_Physical_Commodities_Final.pdf.

expensive financing. Further, because of the bank's expertise in the jet fuel markets and ability to act as market maker, build inventory and engage in transactions in related fuel markets, the financial holding company was able to deliver jet fuel at a lower price than the airline was previously able to achieve purchasing fuel on its own behalf.[5]

Financial holding companies are particularly well suited to provide these services.

In the absence of financial holding companies' participation in these markets, it is not clear that other institutions could serve this intermediary role as effectively. Financial holding companies are willing and able to make supporting trades in the financial and physical commodities markets and assume the related risks, whereas other market participants that are primarily end-users may not be as willing or able to do so. In a market where financial holding companies cannot assume this support position, the market contraction and reduction in flexibility will create greater market volatility, restrict choice for consumers and result in higher costs for market participants.

In addition, we believe that financial holding companies are capable of managing the risks posed by these activities. The intermediary role assumed by financial holding companies in the physical commodities markets is substantially similar to the role these entities assume with regard to other types of financial activities, including in the securities and currency exchange markets, among others. In all of these products and markets, financial holding companies face market, credit and concentration risks. Of course, participation in physical commodities activities also may subject financial holding companies to legal, environmental and reputational risks. However, financial holding companies confront and manage these risks in other circumstances, such as when they foreclose on a company, real property or other assets for non-speculative purposes in satisfaction of debt previously contracted.

The Complementary Activities remain complementary and continue to provide the benefits contemplated by the Board.

Even if financial holding companies were restricted in their ability to transact in physical commodities, they could continue to provide financially settled hedging products. However, the ability and willingness of financial holding companies to do so across a wide range of commodities might be limited without physical market participation because of the intrinsic interrelationship between physical and financial markets. A role in the physical markets allows financial holding companies to understand better the pricing relationships between physical and financial markets, provides them with important and even essential information on events affecting the financial markets. These factors serve to enhance a financial holding company's ability to act as a financial intermediary and to reduce the costs of its services. Participation in the physical markets also facilitates a financial holding company's risk management by providing it with access to broader and better information and risk management tools. Without this participation, the hedging services financial holding companies provide to commercial counterparties would be more limited and more costly. Further, financial holding companies

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5 Id., at 12.

play an important role as merchandisers of physical commodities, facilitating the storage, transmission and distribution of physical commodities through commercial channels. This role is critical to the proper and efficient functioning of the physical markets, because it provides additional channels for physical delivery, as well as of the financial markets, as it ensures that financial holding companies have sufficient expertise and infrastructure in the physical markets to enable them to operate most effectively in the related financial markets.

By participating in both the physical and financial segments of the commodities markets, therefore, financial holding companies can assist in lowering the risk profiles and costs for their customers. Further, financial holding companies can offer competitively priced merchandizing and customized risk management solutions to customers to efficiently meet customers' business and operational needs and mitigate complicated business risks in an efficient and strategic manner.

Accordingly, we believe that the Complementary Activities remain complementary to financial activities. In its orders, the Board found complementarity for a number of reasons, including that the public would benefit by enabling financial holding companies to provide a more efficient and broader variety of market options (for example, because transactions could be settled physically), and that financial holding companies' greater market knowledge could benefit their customers and enhance market competition by allowing them to compete with non-financial holding company entities in the commodities markets.[6] In our view, the market benefits anticipated by the Board in approving these Complementary Activities have been achieved and continue to provide positive benefits for direct participants in the commodities markets and the broader economy. In addition, these entities may still find operational efficiencies in the ability to hold positions in physical commodities to offset customers' derivatives positions, even where those positions are cash settled. This is particularly true because banks are now required to push out commodity derivative activities to affiliates, and such affiliates will need at least the ability to hold commodities as hedges, subject to quantitative limits. In this way, participation in the physical markets provides a better understanding of the financial markets such that financial holding companies can better risk manage their exposure and provide greater liquidity to customers.

[6] See, e.g., Citigroup Inc., 89 Fed. Res. Bull. 508, at 511 (2003); Fortis S.A./N.V., 94 Fed. Res. Bull. C20, at C22 (2008); The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60, at C66 (2008).

Final Considerations and Recommendations

In light of the foregoing discussion and analysis, we strongly urge the Board to consider the significant benefits financial holding companies provide directly to end-users and to the markets through their participation in the physical and financial commodities markets when weighing whether to institute any prohibitions or further restrictions to the current participation of financial holding companies. We appreciate the opportunity to provide these comments and we would welcome the opportunity to provide further assistance to the Board in evaluating these issues.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA